APPENDIX A

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 22540

B & L FARMS CO., ET AL.,

Appellant,

versus

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the Southern District of Florida.

(December 1, 1966.)

Before PHILLIPS,* JONES and BROWN, Circuit Judges.

PER CURIAM: The facts of the suit for a tax refund from which this appeal stems are set forth in the opinion of the district court. *B & L Farms Co.* v. *United States,* 238 F. Supp. 407. The conclusions reached by the district court are correct and its judgment is free from error. That judgment is AFFIRMED.

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*Senior Judge, Tenth Circuit, sitting by designation.

BROWN, Circuit Judge, dissenting in part:

I concur fully in the Court's affirmance of the District Court's disallowance of the claimed deductions under Sections 165 and 167, 26 USCA §§165, 167. But I disagree as to §162, 26 USCA §162.

The Taxpayer entity is the corporate bankrupt. On the date of adjudication the Bankrupt owed large sums for costs incurred in the growing of produce. These were admittedly "ordinary and necessary expenses" for "carrying on [the] trade or business," 26 USCA §162. On adjudication the Bankrupt lost irrevocably control over the use or disposition of corporate assets. From that moment on such assets were held irrevocably for (a) general creditors and (b) administration expenses—each and both items which may have been of an unknown amount at the time, but each of which was ascertainable in due course.

By virtue of our ruling we now hold that the Taxpayer had not "paid" these debts in the year of adjudication and that they were not "paid" until the year in which creditors received dividends. The effect of this is to give the Government a super priority for taxes—taxes not really due and, conversely, to deprive general creditors of $162,000 of assets for further distribution.

By every realistic standard the creditors were "paid" at the moment the Trustee came into possession and control of the Bankrupt's assets under the inescapable obligation to hold and distribute them (or their proceeds) to creditors. Bankruptcy law and tax law ought to coalesce to produce a realistic result.

Prior to bankruptcy the Bankrupt had kept its books and reported its income on a cash basis, on a fiscal year beginning August 1 and ending July 31. During fiscal

year 1958 (ending July 31, 1958) the company incurred debts in excess of $2,500,000 for fertilizer, insecticides, and other deductible business expenses, but as the result of a freeze made no crop. On August 1, 1958, the first day of fiscal 1959, it filed a petition under Chapter XI of the Bankruptcy Act, and failing an arrangement, was adjudicated on June 26, 1959, within the same fiscal 1959 year. The Trustees in bankruptcy have applied for recovery of $162,538.73 in income taxes paid for the year ending July 31, 1956, under an asserted carry-back under Section 172 of the Internal Revenue Code of 1954. This the Government opposes because, though the property of the Bankrupt did pass to the Trustees within fiscal year 1959, the Trustees did not actually *pay* dividends to the creditors until a later year, beyond the permissible carry-back three-year period. From an adverse ruling of the District Court, the Trustees in bankruptcy have prosecuted this appeal.

The District Court and now this Court misconstrues the character and function of the Trustee in bankruptcy. He is far more than a mere "collection agent" for the creditors. Under Section 70a of the Bankruptcy Act, 11 USCA §110a, the Trustee is vested by operation of law as of the date of bankruptcy with title to all of the non-exempt property of a bankrupt. Since the Bankruptcy Act of 1867 the Congress has recognized that insolvent estates are trusts, of which the creditors are the beneficiaries,[1] and this Court has been on record since 1900 as recognizing that these estates belong to the creditors.[2] That the Trustee's obligation, first, foremost, and always, is to the creditors is the consistent theme running throughout the Act. His duties to the bankrupt (as, setting aside

1. Section 44 of the Bankruptcy Act, 11 USCA §72; 2 Collier on Bankruptcy, para. 44.01.

2. Atkins v. Wilcox, 5 Cir., ..., 105 Fed. 595, 5 Am.B.R. 313.

the bankrupt's exemptions[3]) are merely incidental to the proper administration and liquidation of the estate which passes to him by operation of law for the creditors' benefit. His receipts from liquidation of the estate are taxed with the costs of liquidation and with the costs of court (called administrative costs by the District Court), it is true, but this is because the Congress has determined that the creditors, for whom the estate is administered, and not the public at large, must pay the costs directly involved, and not because the Trustee is any the less the creditors' trustee.

Section 63 of the Bankruptcy Act, 11 USCA §103, which matures all of the debts of the bankrupt on the date of bankruptcy (even those which, under the agreement of the parties, do not fall due until after the bankruptcy petition is filed), is the natural corollary of §70. At the instant of bankruptcy the title to the assets vest in the Trustee, in trust for the creditors, pro rata according to the debts held by them as of that same instant. True, at that instant no creditor is entitled to receive, or to demand, from the Trustee any sum certain. The exact amount each creditor will receive must await the converting of the property to cash and the payment of the costs. But mere postponement of enjoyment has never been held to disqualify an interest as "property."[4]

As the District Court has observed, payment in cash *or its equivalent* has long been recognized. The transfer by operation of law of the assets of the bankrupt to the trustee amounted to exactly that.

I would reverse the case.

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3. Section 47a(6) of the Act, 11 USCA §75a(6).

4. Sharing in the distribution of the estate is contingent upon the timely filing of a claim. Section 57n of the Act, 11 USCA §93n, requiring the filing of claims within six months of the first date set for the first meeting of creditors is nothing more than a statute of limitations, and cannot be construed as any divestment of ownership of the property as of the date of bankruptcy.

APPENDIX "B"

FOR THE FIFTH CIRCUIT

No. 22540

B & L FARMS CO., ET AL.,

Appellants,

versus

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court for the Southern District of Florida.

On Petition for Rehearing

(February 15, 1967.)

Before PHILLIPS,* JONES and BROWN, Circuit Judges.

PER CURIAM: The appellants have petitioned the Court for a rehearing and rely upon *Nicholas, trustee,* v. *United States,* 384 U.S. 678, 86 S.Ct. 1674, 16 L.Ed. 2d 853, to support their contention that the opinion and decision of the Court are wrong. Our consideration leads to the conclusion that the *Nicholas* case does not require any change of position on the part of the Court. The petition for rehearing is

DENIED.

BROWN, Circuit Judge, Dissents.

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*Senior Judge, Tenth Circuit, sitting by designation.

APPENDIX "C"

CHARLES R. STUART, PETITIONER, v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket No. 89096. Promulgated November 15, 1938.

In 1933 a judgment was obtained against the petitioner and other defendants of more than $7,000,000 upon the ground of his liability as a director of the Guaranty Building & Loan Association of Los Angeles. The amount of the judgment was far in excess of the value of petitioner's property. In 1934 the petitioner went into voluntary bankruptcy and turned over to the trustee appointed by the court all of his property, which had cost him $76,800. He was discharged from bankruptcy in 1934. Petitioner kept his books of account and made his tax returns upon the cash receipts and disbursements basis. *Held*, that the petitioner in 1934 sustained a loss deductible from gross income of at least $12,621.06—the amount of the net income determined by the respondent for 1934.

Raymond R. Hails, Esq., and *A. L. Moreton, C. P. A.*, for the petitioner.

Alra C. Baird, Esq., for the respondent.

Opinion.

SMITH: In this proceeding the petitioner seeks the redetermination of a deficiency in income tax for 1934 of $756.33. The question in issue is whether the petitioner sustained a deductible loss of at least $12,621.06—the amount of the net income determined by the respondent resulting from the petitioner having, during 1934, turned over to the trustee for his bankrupt estate real and personal property which had cost him $76,800.

The facts have all been stipulated. They may be summarized as follows:

The petitioner is a resident of the City of Glendale, County of Los Angeles, California. He filed an income tax return for 1934 which shows as his total gross income $13,750 representing one-half of the salary which he received from Chas. R. Stuart, Inc. He claimed the deduction from gross income of a loss of $41,200. The return showed a net loss of $28,578.94. The deduction of the $41,200 was disallowed by the respondent in the determination of the deficiency, and a net income of $12,621.06 determined.

The petitioner was a director and vice president of the Guaranty Building & Loan Association of Los Angeles from the date of its organization in 1921 to the time of the confessed defalcation of Gilbert H. Bessemyer in December 1930.

The petitioner also became a director of United States Guaranty Corporation at the time of its organization and continued to act as a director of that corporation at all times between the date of its organization and the time Bessemyer confessed his defalcation.

On or about December 15, 1930, there was filed in the Superior Court of the State of California, in and for the County of Los Angeles, an action entitled "W. H. Douglas v. Guaranty Building and Loan Association of Los Angeles, et al., No. 313-332." The petitioner was made a defendant in that action as a director of the Building & Loan Association. Thereafter, and on or about September 28, 1933, pursuant to stipulation, a judgment was entered against the petitioner and other defendants in that action in the amount of $7,661,793. The petitioner was

insolvent at all times between the date of the judgment on September 28, 1933, and January 9, 1934, when a petition in voluntary bankruptcy was filed.

On April 29, 1931, Ernest U. Schroeter, as trustee in bankruptcy for the United States Guaranty Corporation, filed a suit in the Superior Court of the State of California, in and for the County of Los Angeles, No. 320-640, against Gilbert H. Bessemyer, petitioner, and the other directors of the United States Guaranty Corporation, praying for a judgment of $193,333.86. That action was never brought to trial but was dismissed as to petitioner on May 15, 1934.

During 1931 seven suits were instituted in the Municipal Court of the City of Los Angeles in which petitioner was named a defendant. All of the suits were based either upon petitioner's liability as a director or a stockholder in the Guaranty Building & Loan Association of Los Angeles or United States Guaranty Corporation. With the exception of one of the suits, in which judgment was rendered for the defendant for costs, the remaining suits are still pending and unadjudicated.

On January 9, 1934, the petitioner filed in the United States District Court for the Southern District of California a voluntary petition in bankruptcy, and was adjudicated a bankrupt. On February 19, 1934, Hiram E. Casey was appointed trustee in bankruptcy in the bankruptcy proceeding.

By virtue of his appointment as trustee, Hiram E. Casey acquired from the petitioner by operation of law and without other consideration title to all of the property belonging to petitioner. Actual delivery of the property

was made to the trustee by the petitioner during the month of February 1934. The assets turned over to the trustee were as follows:

Item No.	Description of assets	Cost to petitioner
1	Certain real property located on Vine Street in Los Angeles, known as Leland tract, acquired Dec. 24, 1925, and Apr. 17, 1927	$41,200
2	34 shares of the capital stock of Charles R. Stuart, Inc., a California corporation, evidenced by certificate No. 1 (acquired in 1933)	850
3	317 shares of the capital stock of Harry E. Jones, Inc., evidenced by certificates Nos. 117 and 155 (acquired from 3/4/26 to 3/12/30)	31,830
4	7 shares of the capital stock of Transamerica Corporation	420
5	Special life membership in Flintridge Country Club (acquired about 1921)	1,000
6	Northeasterly half of lot 35, and all of lot 36 of tract 7891, County of Los Angeles	1,500

The total claims proven against petitioner's bankrupt estate were as follows:

Claimant	Court and case No.	Amount of claim
A. N. Kemp, trustee in Equity for Guaranty Building & Loan Association of Los Angeles.	Superior 313-332	$7,661,793.00
Andrew J. Jenkins	Municipal 236-028	182.93
Ernest U. Schroeter, as trustee in Bankruptcy for United States Guaranty Corporation.	Superior 320-640	193,333.86
Anthony J. Jacobs	Municipal 238-857	977.92
Saul S. and Ida Klein	Municipal 238-855	1,285.42
Total		7,857,573.13

No dividends have been paid as yet to any of these claimants by the trustee.

In his income tax return for 1934 petitioner claimed no loss for any assets turned over to the trustee in bankruptcy except on the Leland Tract which was acquired by the petitioner on December 24, 1925, and April 17, 1927, at a cost of $41,200.

The petitioner has at all times made his income tax returns, including his return for 1934, on the cash receipts and disbursements basis.

Petitioner received his discharge in bankruptcy on June 4, 1934.

The petitioner sustained a loss in 1934 as the result of acting as a director of the Guaranty Building & Loan Association. The loss sustained, in the amount of at least $12,621.06, is a legal deduction from gross income.

The question presented by this proceeding is whether the petitioner sustained a loss in 1934 which is deductible from gross income; and, if so, the amount thereof. The respondent submits that petitioner was insolvent in 1933 and that he sustained no deductible loss when he turned his property over to the trustee in bankruptcy.

The reason for the disallowance by the respondent of the claimed deduction of $41,200 from the gross income of 1934 is as follows:

> The loss on the sale of the Leland Tract has been disallowed in accordance with I. T. 2898, Cumulative Bulletin XIV—1, page 70, which states that a taxpayer may not deduct as a loss in computing his net income either for the year in which he was adjudicated a bankrupt or for the year in which he received a discharge in bankruptcy under the National Bankruptcy Act, the cost or other basis of the property turned over by him to the trustee in bankruptcy to be applied in payment of his indebtedness in accordance with the provisions of that Act.

The pertinent provisions of the Revenue Act of 1934 are as follows:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * * * * *

(e) LOSSES BY INDIVIDUALS.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. * * *

Article 23 (e)-1 of Regulations 86 provides in material part as follows:

Losses by individuals.—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, * * *

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. * * *

In his brief the respondent submits:

* * * the petitioner's contentions [with respect to the claimed deduction of a loss of $41,200] are without merit because the facts clearly show that he made no payment on the judgment as such at any time and if the books of petitioner had been kept on the ac-

crual system then the loss, if any, would have been deductible in 1933 when the judgment was entered against him. While it is true that by the transfer of his assets to the trustee in bankruptcy, the petitioner was forever divested of his said property, nevertheless he at the same time as a result of the whole proceedings, namely, his discharge in bankruptcy, was benefited by the cancellation of adjudicated indebtedness against him, which amounted to a sum that was many times more than the value of the property. * * *

In article 43-2 of Regulations 86, promulgated under the provisions of the Revenue Act of 1934, it is stated:

> * * * Judgments or other binding adjudications, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. * * *

The Board is of the opinion that there can be no question but that the petitioner sustained a loss of 1933 or 1934 greatly in excess of $12,621.06, the amount of the net income determined by the respondent. He clearly lost in either one year or the other all of his property which cost him $76,800.

The respondent makes no contention that the loss was not one sustained "in trade or business." We think that no such contention could validly be made. The judgment was obtained against the petitioner by reason of his having been a director and vice president of the Guaranty Building & Loan Association of Los Angeles. This was

a business undertaking of the petitioner and the loss was one sustained in trade or business.

The respondent admits that if the petitioner had kept his books of account upon the accrual basis rather than upon the cash receipts and disbursements basis the loss sustained by the petitioner would have been a legal deduction from the gross income of 1933, the year in which a final judgment was obtained against him. Since the petitioner kept his books of account and made his tax returns upon the cash receipts and disbursements basis the loss was not "sustained" in 1933 within the meaning of the income tax acts. We do not believe that it was the intention of Congress to deprive taxpayers making their returns on a cash receipts and disbursements basis of losses which would be deductible in returns made on the accrual basis. The only difference in treatment countenanced by the income tax law is the year of deduction. The petitioner made his returns on a cash receipts and disbursements basis. His loss was sustained in 1934, the year in which he lost his property. Cf. *Sidney-Hill System of Health Building Co.*, 12 B. T. A. 548.

The contention of the respondent appears to be that since the petitioner went into bankruptcy in 1934 he is precluded from deducting the loss. His sole reliance is on I.T. 2898, *supra*, which was apparently written to cover this case. We are of the opinion that the bankruptcy proceeding has nothing to do with the deductibility of the loss.

In *Yoder* v. *Nauts*, 34 Fed. (2d) 450, it was held that, where an officer of a corporation guaranteed another against certain losses anticipated as possible in 1920 and this guaranty ripened into liquidated indebtedness in 1921, which was met by delivery of promissory notes, such losses

became "business losses" to the taxpayer as and when the notes were paid.

In *John P. Dillon,* 9 B. T. A. 177, it was held that a payment made by a guarantor for relief from liability, past and future, under a guarantee contract constituted a deductible loss.

The Board has held that where a payment was made in satisfaction of judgments obtained under mechanics' liens the payment was a legal deduction from gross income, *Leichner & Jordan Co.*, 4 B. T. A. 133; that where profits were surrendered in order to avoid a damage suit the amount thereof was likewise a legal deduction, *W. R. Hervey,* 25 B. T. A. 1282; also, that where a payment was made to settle a controversy over stock fraudulently issued the amount paid was a legal deduction, *North American Investment Co.*, 24 B. T. A. 419.

In O. D. 978, Cumulative Bulletin No. 5, p. 135, a taxpayer was allowed a deduction on account of payment of a judgment based upon his misrepresentations in a real estate deal. In O. D. 1091, Cumulative Bulletin No. 5, p. 139, it was held that an amount paid out in compromise of a judgment recovered in a suit against a taxpayer on account of dereliction and neglect of his duty while serving as a director of a bank was an allowable deduction. In I.T. 1853, Cumulative Bulletin II-2, p. 124, it was held that an amount paid in liquidation of a judgment recovered against the taxpayer for the recovery of secret profits arising from the purchase of certain property on behalf of a corporation formed by him and others was deductible from gross income.

In *In re Park's Estate* (C.C.A., 2d Cir.) 58 Fed. (2d) 965, it was held that an amount paid in to a bank by the president to prevent closing thereof because of the treas-

urer's defalcations was not deductible from the president's income. The court observed that the president "did not put in his $100,000 in additional money in settlement of any recognized legal liability so to do." It held that the amount was simply an additional investment in the shares of stock owned by the president. That case is distinguishable from the proceeding at bar, for here the petitioner had a legal liability arising from his being a director of the Guaranty Building & Loan Association of Los Angeles.

The Board is of the opinion that it was not the intention of Congress in the enactment of the Revenue Act of 1934, or of any other revenue act, to disallow the deduction from gross income of losses arising from purely business transactions. We think it clear that if the petitioner in 1934 had sold the assets which he later turned in to the trustee in bankruptcy and paid the cash in compromise of his liability on the judgment, the amount paid would be a legal deduction from gross income. We can not see how the fact that he paid his property in to a trustee in bankruptcy bars him from the deduction of the loss actually sustained.

It will be noted above that the total claims proven against the petitioner's bankrupt estate included three claims as follows:

Claimant	Court case No.	Amount of claim
Andrew J. Jenkins	Municipal 236-028	$ 182.93
Anthony J. Jacobs	Municipal 238-857	977.92
Saul S. and Ida Klein	Municipal 238-855	1,285.42
Total		2,446.27

The stipulated facts do not show the nature of these proven claims. For aught shown to the contrary they may have been claims against the petitioner's bankrupt estate which were not incurred "in trade or business."

It certainly can not be said that a taxpayer sustains a deductible loss in respect of claims proven against his bankrupt estate which were not incurred "in trade or business." The total of such claims was, however, in the instant proceeding, insignificant. The balance of the claims proven against the bankrupt's estate arose from transactions connected with the petitioner's trade or business. To the extent that the petitioner paid off such claims in the taxable year the amount is a legal deduction from gross income.

There may also be a question as to whether the petitioner would be in any event entitled to deduct from his gross income for 1934 the full amount of $76,800 representing the entire cost of all of the property turned in by him to the trustee in bankruptcy in that year. It is questionable whether his purchase of a special life membership in the Flintridge Country Club at a cost of $1,000 is an item of property which was purchased with the expectation of realizing a profit therefrom. It would appear that the investment was for the personal benefit of the petitioner. It may also be true that certain other items of property turned over to the trustee were not purchased with any intention of realizing a profit from them. But we are satisfied that the petitioner's investment of $31,830 in 317 shares of the capital stock of Harry E. Jones, Inc., and the investment of other amounts of money in personal property were made by the petitioner for the purpose of realizing a profit therefrom, and that the cost to the petitioner of such items of property was much in excess of $12,621.06, the amount of the net income determined by the respondent in the determination of the deficiency. The petitioner is entitled to the deduction of a loss of $12,621.06. With the allowance of such deduction the petitioner had no net income for 1934.

Reviewed by the Board.

Judgment of no deficiency will be entered.

APPENDIX "D"

§ 103. Debts which may be proved

(a) Debts of the bankrupt may be proved and allowed against his estate which are founded upon (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition by or against him, whether then payable or not, with any interest thereon which would have been recoverable at that date or with a rebate of interest upon such as were not then payable and did not bear interest; (2) costs taxable against a bankrupt who was at the time of the filing of the petition by or against him plaintiff in a cause of action which would pass to the trustee and which the trustee declines to prosecute after notice; (3) a claim for taxable costs incurred in good faith by a creditor before the filing of the petition in an action to recover a probable[1] debt; (4) an open account, or a contract express or implied; (5) provable debts reduced to judgments after the filing of the petition and before the consideration of the bankrupt's application for a discharge, less costs incurred and interest accrued after the filing of the petition and up to the time of the entry of such judgments; (6) an award of an industrial-accident commission, body, or officer of any State having jurisdiction to make awards of workmen's compensation in case of injury or death from injury, if such injury occurred prior to adjudication; (7) the right to recover damages in any action for negligence instituted prior to and pending at the time of the filing of the petition in bankruptcy; (8) contingent debts and contingent contractual liabilities; or (9) claims

1. So in original. Probably should read "provable".

for anticipatory breach of contracts, executory in whole or in part, including unexpired leases of real or personal property: *Provided, however,* That the claim of a landlord for damages for injury resulting from the rejection of an unexpired lease of real estate or for damages or indemnity under a covenant contained in such lease shall in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises to the landlord or the date of reentry of the landlord, whichever first occurs, whether before or after bankruptcy, plus an amount equal to the unpaid rent accrued, without acceleration, up to such date: *And provided further,* That in the case of an assignment of any such claim for damages, the court shall, in determining the amount thereof, examine the circumstances of the assignment and the consideration paid or to be paid therefor, and may allow the claim of the assignee in such amount, subject to the provisions of the foregoing proviso of this clause, as will be fair and equitable.

(b) In the interval after the filing of an involuntary petition and before the appointment of a receiver or the adjudication, whichever first occurs, a claim arising in favor of a creditor by reason of property transferred or services rendered by the creditor to the bankrupt for the benefit of the estate shall be provable to the extent of the value of such property or services.

(c) Notwithstanding any State law to the contrary, the rejection of an executory contract or unexpired lease, as provided in this title, shall constitute a breach of such contract or lease as of the date of the filing of the petition initiating a proceeding under this title.

(d) Where any contingent or unliquidated claim has been proved, but, as provided in subdivision (d) of section 93 of this title, has not been allowed, such claim shall not be deemed proved under this title. July 1, 1898, c. 541, § 63, 30 Stat. 562; June 7, 1934, c. 424, § 4 (a), 48 Stat. 923; June 18, 1934, c. 580, 48 Stat. 991; June 5, 1936, c. 512, § 1, 49 Stat. 1475; June 22, 1938, c. 575, § 1, 52 Stat. 873; July 7, 1952, c. 579, § 18, 66 Stat. 426.

§ 110. Title to property

(a) The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt, to all of the followng kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks, and in applications therefor: *Provided*, That in case the trustee, within thirty days after appointment and qualification, does not notify the applicant for a patent, copyright, or trade-mark of his election to prosecute the application to allowance or rejection, the bankrupt may apply to the court for an order revesting him with the title thereto, which petition shall be granted unless for cause shown by the trustee the court grants further time to the trustee for making such election; and such applicant may, in any event, at any time petition the court to be revested with such title in case the trustee shall fail to prosecute such application with reasonable diligence; and the court, upon revesting the bankrupt with such title, shall direct the trustee to execute proper instruments of transfer to make the same effective in law and upon the

records; (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person; (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered: *Provided*, That rights of action ex delicto for libel, slander, injuries to the person of the bankrupt or of a relative, whether or not resulting in death, seduction, and criminal conversation shall not vest in the trustee unless by the law of the State such rights of action are subject to attachment, execution, garnishment, sequestration, or other judicial process: *And provided further*, That when any bankrupt, who is a natural person, shall have any insurance policy which has a cash surrender value payable to himself, his estate, or personal representatives, he may, within thirty days after the cash surrender value has been ascertained and stated to the trustee by the company issuing the same, pay or secure to the trustee the sum so ascertained and stated, and continue to hold, own, and carry such policy free from the claims of the creditors participating in the distribution of his estate under the bankruptcy proceedings, otherwise the policy shall pass to the trustee as assets; (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property; (7) contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests in real property, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates; and (8) property held by an assignee for the benefit of

creditors appointed under an assignment which constituted an act of bankruptcy, which property shall, for the purposes of this title, be deemed to be held by the assignee as the agent of the bankrupt and shall be subject to the summary jurisdiction of the court.

All property, wherever located, except insofar as it is property which is held to be exempt, which vests in the bankrupt within six months after bankruptcy by bequest, devise or inheritance shall vest in the trustee and his successor or successors, if any, upon his or their appointment and qualification, as of the date when it vested in the bankrupt, and shall be free and discharged from any transfer made or suffered by the bankrupt after bankruptcy.

All property, wherever located, except insofar as it is property which is held to be exempt, in which the bankrupt has at the date of bankruptcy an estate or interest by the entirety and which within six months after bankruptcy becomes transferable in whole or in part solely by the bankrupt shall, to the extent it becomes so transferable, vest in the trustee and his successor or successors, if any, upon his or their appointment and qualification, as of the date of bankruptcy.

The title of the trustee shall not be affected by the prior possession of a receiver or other officer of any court.

(b) Within sixty days after the adjudication, the trustee shall assume or reject any executory contract, including unexpired leases of real property: *Provided, however,* That the court may for cause shown extend or reduce such period of time. Any such contract or lease not assumed or rejected within such time, whether or not a trustee has been appointed or has qualified, shall be deemed to be rejected. A trustee shall file, within sixty days after adjudication, a statement under oath showing

which, if any, of the contracts of the bankrupt are executory in whole or in part, including unexpired leases of real property, and which, if any, have been rejected by the trustee: *Provided, however,* That the court may for cause shown extend or reduce such period of time. Unless a lease of real property shall expressly otherwise provide, a rejection of such lease or of any covenant therein by the trustee of the lessor shall not deprive the lessee of his estate. A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning the same; but an express covenant that an assignment by operation of law or the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same shall be enforceable. A trustee who elects to assume a contract or lease of the bankrupt and who subsequently, with the approval of the court and upon such terms and conditions as the court may fix after hearing upon notice to the other party to the contract or lease, assigns such contract or lease to a third person, shall not be liable for breaches occurring after such assignment.

(c) The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.

(d) After bankruptcy and either before adjudication or before a receiver takes possession of the property of the bankrupt, whichever first occurs—

(1) A transfer of any of the property of the bankrupt, other than real estate, made to a person acting in good faith shall be valid against the trustee if made for a present fair equivalent value or, if not made for a present fair equivalent value, then to the extent of the present consideration actually paid therefor, for which amount the transferee shall have a lien upon the property so transferred;

(2) A person indebted to the bankrupt or holding property of the bankrupt may, if acting in good faith, pay such indebtedness or deliver such property, or any part thereof, to the bankrupt or upon his order, with the same effect as if the bankruptcy were not pending;

(3) A person having actual knowledge of such pending bankruptcy shall be deemed not to act in good faith unless he has reasonable cause to believe that the petition in bankruptcy is not well founded;

(4) The provisions of paragraphs (1) and (2) of this subdivision shall not apply where a receiver or trustee appointed by a United States or State court is in possession of all or the greater portion of the non-exempt property of the bankrupt;

(5) A person asserting the validity of a transfer under this subdivision shall have the burden of proof. Except as otherwise provided in this subdivision and in subdivision g of section 44 of this title, no transfer by or in behalf of the bankrupt after the date of bankruptcy shall be valid against the trustee: *Provided, however,* That nothing in this title shall impair the negotiability of currency or negotiable instruments.

(e) (1) A transfer made or suffered or obligation incurred by a debtor or adjudged a bankrupt under this title which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this title, shall be null and void as against the trustee of such debtor.

(2) All property of the debtor affected by any such transfer shall be and remain a part of his assets and estate, discharged and released from such transfer and shall pass to, and every such transfer or obligation shall be avoided by, the trustee for the benefit of the estate: *Provided, however,* That the court may on due notice order such transfer or obligation to be preserved for the benefit of the estate and in such event the trustee shall succeed to and may enforce the rights of such transferee or obligee. The trustee shall reclaim and recover such property or collect its value from and avoid such transfer or obligation against whoever may hold or have received it, except a person as to whom the transfer or obligation specified in paragraph (1) of this subdivision is valid under applicable Federal or state laws.

(3) For the purpose of such recovery or of the avoidance of such transfer or obligation, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

(f) The court shall appoint a competent and disinterested appraiser and upon cause shown may appoint additional appraisers, who shall appraise all the items of real and personal property belonging to the bankrupt estate and who shall prepare and file with the court their report thereof. Real and personal property shall, when practicable, be sold subject to the approval of the court. It shall

not be sold otherwise than subject to the approval of the court for less than 75 per centum of its appraised value. Whenever any sale of real or personal property of any bankrupt is made by or through any auctioneer employed by the court, receiver, or trustee, such auctioneer, if an individual or a partnership, shall be a bonafide resident and citizen of the judicial district in which the property to be sold is situated, or, if a corporation, shall be lawfully domesticated and authorized to transact such business in the State in which said judicial district is located.

(g) The title to property of a bankrupt estate which has been sold, as herein provided, shall be conveyed to the purchaser by the trustee.

(h) Repealed. July 7, 1952, c. 579, § 23(g), 66 Stat. 430.

(i) Upon the confirmation of an arrangement or plan, or at such later time as may be provided by the arrangement or plan, or in the order confirming the arrangement or plan, the title to the property dealt with shall revest in the bankrupt or debtor, or vest in such other person as may be provided by the arrangement or plan or in the order confirming the arrangement or plan. July 1, 1898, c. 541, § 70, 30 Stat. 565; Feb. 5, 1903, c. 487, § 16, 32 Stat. 800; May 27, 1926, c. 406, § 16, 44 Stat. 667; June 22, 1938, c. 575, § 1, 52 Stat. 879; Mar. 18, 1950, c. 70, § 2, 64 Stat. 23; July 7, 1952, c. 579, § 23, 66 Stat. 429.

* * * * * * * *

(b) The trustee shall assume or reject an executory contract, including an unexpired lease of real property, within sixty days after the adjudication or within thirty days after the qualification of the trustee, whichever is later, but the court may for cause shown extend or reduce the time. Any such contract or lease not assumed or rejected within that time shall be deemed to be rejected.

If a trustee is not appointed, any such contract or lease shall be deemed to be rejected within thirty days after the date of the order directing that a trustee be not appointed. A trustee shall file, within sixty days after adjudication or within thirty days after he has qualified, whichever is later, unless the court for cause shown extends or reduces the time, a statement under oath showing which, if any, of the contracts of the bankrupt are executory in whole or in part, including unexpired leases of real property, and which, if any, have been rejected by the trustee. Unless a lease of real property expressly otherwise provides, a rejection of the lease or of any covenant therein by the trustee of the lessor does not deprive the lessee of his estate. A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning the same; but an express covenant that an assignment by operation of law or the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same is enforcible. A trustee who elects to assume a contract or lease of the bankrupt and who subsequently, with the approval of the court and upon such terms and conditions as the court may fix after hearing upon notice to the other party to the contract or lease, assigns the contract or lease to a third person, is not liable for breaches occurring after the assignment.

(c) The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee shall have as of the date of bankruptcy

the rights and powers of: (1) a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists, (2) a creditor who upon the date of bankruptcy obtained an execution returned unsatisfied against the bankrupt, whether or not such a creditor exists, and (3) a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceedings upon all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt upon a simple contract could have obtained such a lien, whether or not such a creditor exists. If a transfer is valid in part against creditors whose rights and powers are conferred upon the trustee under this subdivision, it shall be valid to a like extent against the trustee. In cases where repugnancy or inconsistency exists with reference to the rights and powers in this subdivision conferred, the trustee may elect which rights and powers to exercise with reference to a particular party, a particular remedy, or a particular transaction, without prejudice to his right to maintain a different position with reference to a different party, a different remedy, or a different transaction.

* * * * * * *

(f) The court shall appoint a competent and disinterested appraiser and upon cause shown may appoint additional appraisers, who shall appraise all the items of real and personal property belonging to the bankrupt estate and who shall prepare and file with the court their report thereof. Real and personal property shall, when practicable, be sold subject to the approval of the court. It shall not be sold otherwise than subject to the approval of the court for less than 75 per centum of its appraised value. Whenever a sale of real or personal property of a bankrupt is made by or through an auctioneer employed

by the court, receiver, or trustee, the auctioneer must be a duly licensed or authorized auctioneer in the place where the sale is to be conducted. As amended Sept. 25, 1962, Pub. L. 87—681, §§ 9, 10, 76 Stat. 571; July 5, 1966, Pub. L. 89—495, § 5, 80 Stat. 269.

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SUBCHAPTER I—CONSTRUCTION

§ 701. Exclusive application of chapter

The provisions of this chapter shall apply exclusively to proceedings under this chapter. July 1, 1898, c. 541, § 301, as added June 22, 1938, c. 575, § 1, 52 Stat. 905.

§ 702. Application of other provisions

The provisions of chapters 1 to 7, inclusive, of this title shall, insofar as they are not inconsistent with or in conflict with the provisions of this chapter, apply in proceedings under this chapter. For the purposes of such application, provisions relating to "bankrupts" shall be deemed to relate also to "debtors", and "bankruptcy proceedings" or "proceedings in bankruptcy" shall be deemed to include proceedings under this chapter. For the purposes of such application the date of the filing of the petition in bankruptcy shall be taken to be the date of the filing of an original petition under section 722 of this title, and the date of adjudication shall be taken to be the date of the filing of the petition under sections 721 or 722 of this title except where an adjudication had previously been entered. July 1, 1898, c. 541, § 302, as added June 22, 1938, c. 575, § 1, 52 Stat. 905.

§ 707. Creditors; debts; claims

Unless inconsistent with the context and for the purposes of an arrangement providing for an extension of time for payment of debts in full and applicable exclusively to the debts to be extended—

(1) "creditors" shall include the holders of all unsecured debts, demands, or claims of whatever character against a debtor, whether or not provable as debts under section 103 of this title and whether liquidated or unliquidated, fixed or contingent; and

(2) "debts" or "claims" shall include all unsecured debts, demands, or claims of whatever character against a debtor, whether or not provable as debts under section 103 of this title and whether liquidated or unliquidated, fixed or contingent. July 1, 1898, c. 541, § 307, as added June 22, 1938, c. 575, § 1, 52 Stat. 906.

§ 162. Trade or business expenses

(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but

amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

(b) Charitable contributions and gifts excepted.—No deduction shall be allowed under subsection (a) for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section.

(c) Improper payments to officials or employees of foreign countries.—No deduction shall be allowed under subsection (a) for any expenses paid or incurred if the payment thereof is made, directly or indirectly, to an official or employee of a foreign country, and if the making of the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee.

(d) Capital contributions to Federal National Mortgage Association.—For purposes of this subtitle, whenever the amount of capital contributions evidenced by a share of stock issued pursuant to section 303(c) of the Federal National Mortgage Association Charter Act (12 U.S.C., sec. 1718) exceeds the fair market value of the stock as of the issue date of such stock, the initial holder of the stock shall treat the excess as ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

(e) Appearances, etc., with respect to legislation.—

(1) In general.—The deduction allowed by subsection (a) shall include all the ordinary and necessary expenses (including, but not limited to, traveling expenses described in subsection (a) (2) and the cost of preparing testimony) paid or incurred during

the taxable year in carrying on any trade or business—

(A) in direct connection with appearances before, submission of statements to, or sending communications to, the committees, or individual members, of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing with respect to legislation or proposed legislation of direct interest to the taxpayer, or

(B) in direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization,

and that portion of the dues so paid or incurred with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities described in subparagraphs (A) and (B) carried on by such organization.

(2) **Limitation.**—The provisions of paragraph (1) shall not be construed as allowing the deduction of any amount paid or incurred (whether by way of contribution, gift, or otherwise)—

(A) for participation in, or intervention in, any political campaign on behalf of any candidate for public office, or

(B) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums.

(f) Cross reference.—

For special rule relating to expenses in connection with subdividing real property for sale, see section 1237.

Aug. 16, 1954, c. 736, 68A Stat. 45; Sept. 2, 1958, Pub. L. 85—866, Title I, § 5(a), 72 Stat. 1608; Sept. 14, 1960, Pub. L. 86—779, §§ 7(b), 8(a), 74 Stat. 1002, 1003; Oct. 16, 1962, Pub. L. 87—834, §§ 3(a), 4(b), 76 Stat. 973, 976.

§ 165. Losses

(a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100 limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one

individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been claimed for estate tax purposes in the estate tax return.

(d) Wagering losses.—Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.

(e) Theft losses.—For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

(f) Capital losses.—Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) Worthless securities.—

(1) General rule.—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) Security defined.—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) Securities in affiliated corporation.—For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corpo-

ration shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

(h) Disaster losses.—Notwithstanding the provisions of subsection (a), any loss

(1) attributable to a disaster which occurs during the period following the close of the taxable year and on or before the time prescribed by law for filing the income tax return for the taxable year (determined without regard to any extension of time), and

(2) occurring in an area subsequently determined by the President of the United States to warrant assistance by the Federal Government under sections 1855-1855g of title 42,

at the election of the taxpayer, may be deducted for the taxable year immediately preceding the taxable year in which the disaster occurred. Such deduction shall not be in excess of so much of the loss as would have been deductible in the taxable year in which the casualty occurred. If an election is made under this subsection, the

casualty resulting in the loss will be deemed to have occurred in the taxable year for which the deduction is claimed.

(i) Certain property confiscated by the Government of Cuba.—

(1) Treatment as subsection (c) (3) loss.—For purposes of this chapter, in the case of an individual who was a citizen of the United States, or a resident alien, on December 31, 1958, any loss of property which—

(A) was sustained by reason of the expropriation, intervention, seizure, or similar taking of the property, before January 1, 1964, by the government of Cuba, any political subdivision thereof, or any agency or instrumentality of the foregoing, and

(B) was not a loss described in paragraph (1) or (2) of subsection (c),

shall be treated as a loss to which paragraph (3) of subsection (c) applies. In the case of tangible property, the preceding sentence shall not apply unless the property was held by the taxpayer, and was located in Cuba, on December 31, 1958.

(2) Special rules.—

(A) For purposes of subsection (a), any loss described in paragraph (1) shall be treated as having been sustained on October 14, 1960, unless it is established that the loss was sustained on some other day.

(B) For purposes of subsection (a), the fair market value of property held by the taxpayer on December 31, 1958, to which paragraph (1) applies, on the day on which the loss of such property was sustained, shall be its fair market value on December 31, 1958.

(C) For purposes of section 172, a loss described in paragraph (1) shall not be treated as an expropriation loss within the meaning of section 172(k).

(D) For purposes of section 6601, the amount of any tax imposed by this title shall not be reduced by virtue of this subsection for any period prior to February 26, 1964.

(3) Refunds or credits.—Notwithstanding any law or rule of law, refund or credit of any overpayment attributable to the application of paragraph (1) may be made or allowed if claim therefor is filed before January 1, 1965. No interest shall be allowed with respect to any such refund or credit for any period prior to February 26, 1964.

(j) Cross references.—

(1) For special rule for banks with respect to worthless securities, see section 582.

(2) For disallowance of deduction for worthlessness of securities to which subsection (g) (2) (C) applies, if issued by a political party or similar organization, see section 271.

(3) For special rule for losses on stock in a small business investment company, see section 1242.

(4) For special rule for losses of a small business investment company, see section 1243.

(5) For special rule for losses on small business stock, see section 1244.

Aug. 16, 1954, c. 736, 68A Stat. 49; Sept. 2, 1958, Pub.L. 85-866, Title I, §§ 7, 57(c) (1), Title II, § 202(a), 72 Stat. 1608, 1646, 1676; Mar. 31, 1962, Pub.L. 87-426, § 2(a), 76 Stat. 51; Feb. 26, 1964, Pub.L. 88-272, Title II, §§ 208(a), 238, 78 Stat. 43, 128; June 30, 1964, Pub.L. 88-348, § 3(a), 78 Stat. 237.

§ 172. Net operating loss deduction

(a) Deduction allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net operating loss carrybacks and carryovers.—

(1) Years to which loss may be carried.—

(A) (i) Except as provided in clause (ii) and in subparagraph (D), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

(ii) In the case of a taxpayer with respect to a taxable year ending on or after December 31, 1962, for which a certification has been issued under section 317 of the Trade Expansion Act of 1962, a net operating loss for such taxable year shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.

(B) Except as provided in subparagraphs (C) and (D), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(C) In the case of a taxpayer which is a regulated transportation corporation (as defined in subsection (j) (1)), a net operating loss for any taxable year ending after December 31, 1955, shall (except as provided in subsection (j)) be a net operating loss carryover to each of the 7 taxable years following the taxable year of such loss.

(D) In the case of a taxpayer which has a foreign expropriation loss (as defined in subsection (k)) for any taxable year ending after December 31, 1958, the portion of the net operating loss for such year attributable to such foreign expropriation loss shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 10 taxable years following the taxable year of such loss.

(2) Amount of carrybacks and carryovers.—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction—

(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1) (D), be carried back to such prior taxable year,

and the taxable income so computed shall not be considered to be less than zero. For purposes of this paragraph, if a portion of the net operating loss for the loss year is attributable to a foreign expropriation loss to which paragraph (1) (D) applies, such portion shall be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss.

(3) Special rules.—

(A) Paragraph (1) (A) (ii) shall apply only if—

(i) there has been filed, at such time and in such manner as may be prescribed by the Secretary or his delegate, a notice of filing of the application under section 317 of the Trade Expansion Act of 1962 for tax assistance, and, after its issuance, a copy of the certification under such section, and

(ii) the taxpayer consents in writing to the assessment, within such period as may be agreed upon with the Secretary or his delegate, of any deficiency for any year to the extent attributable to the disallowance of a deduction previously allowed with respect to such net operating loss, even though at the time of filing such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(B) In the case of—

(i) a partnership and its partners, or

(ii) an electing small business corporation under subchapter S and its shareholders,

paragraph (1) (A) (ii) shall apply as determined under regulations prescribed by the Secretary or his delegate. Such paragraph shall apply to a net operating loss of a partner or such a shareholder only

if it arose predominantly from losses in respect of which certifications under section 317 of the Trade Expansion Act of 1962 were filed under this section.

(C) Paragraph (1) (D) shall apply only if—

(i) the foreign expropriation loss (as defined in subsection (k)) for the taxable year equals or exceeds 50 percent of the net operating loss for the taxable year.

(ii) in the case of a foreign expropriation loss for a taxable year ending after December 31, 1963, the taxpayer elects (at such time and in such manner as the Secretary or his delegate by regulations prescribes) to have paragraph (1) (D) apply, and

(iii) in the case of a foreign expropriation loss for a taxable year ending after December 31, 1958, and before January 1, 1964, the taxpayer elects (in such manner as the Secretary or his delegate by regulations prescribes) on or before December 31, 1965, to have paragraph (1) (D) apply.

(D) If a taxpayer makes an election under subparagraph (C) (iii), then (notwithstanding any law or rule of law), with respect to any taxable year ending before January 1, 1964, affected by the election—

(i) the time for making or changing any choice or election under subpart A of part III of subchapter N (relating to foreign tax credit) shall not expire before January 1, 1966,

(ii) any deficiency attributable to the election under subparagraph (C) (iii) or to the application of clause (i) of this subparagraph may be assessed at any time before January 1, 1969, and

(iii) refund or credit of any overpayment attributable to the election under subparagraph (C) (iii) or to the application of clause (i) of this subparagraph may be made or allowed if claim therefor is filed before January 1, 1969.

(c) Net operating loss defined.—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) Modifications.—The modifications referred to in this section are as follows:

(1) Net operating loss deduction.—No net operating loss deduction shall be allowed.

(2) Capital gains and losses of taxpayers other than corporations.—In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) Deduction for personal exemptions.—No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness deductions of taxpayers other than corporations.—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business,

shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2) (B), and (3) shall be taken into account;

(C) any deduction allowable under section 165(c) (3) (relating to casualty losses) shall not be taken into account; and

(D) any deduction allowed under section 404 or section 405(c) to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c) (1) shall not be treated as attributable to the trade or business of such individual.

(5) Special deductions for corporations.—No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) Computation of deduction for dividends received, etc.—The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a) (1) (B) of such section.

(e) Law applicable to computations.—In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954.

(f) Taxable years beginning in 1953 and ending in 1954.—In the case of a taxable year beginning in 1953 and ending in 1954—

(1) In lieu of the amount specified in subsection (c), the net operating loss for such year shall be the sum of—

(A) that portion of the net operating loss for such year computed without regard to this subsection which the number of days in the loss year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss for such year computed under section 122 of the Internal Revenue Code of 1939 as if this section had not been enacted which the number of days in the loss year before January 1, 1954, bears to the total number of days in such year.

(2) The amount of any net operating loss for such year which shall be carried to the second preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1953, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the second taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the second preceding taxable year.

(3) The net operating loss deduction for such year shall be, in lieu of the amount specified in section 122(c) of the Internal Revenue Code of 1939, the sum of—

(A) that portion of the net operating loss deduction for such year, computed as if subsection (a) of this section were applicable to the taxable year, which the number of days in such year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss deduction for such year, computed under section 122 (c) of the Internal Revenue Code of 1939 as if this paragraph had not been enacted, which the number of days in such year before January 1, 1954, bears to the total number of days in such year.

(4) For purposes of the second sentence of subsection (b) (2), the taxable income for such year shall be the sum of—

(A) that portion of the net income for such year, computed without regard to this paragraph, which the number of days in such year before January 1, 1954, bears to the total number of days in such year, and

(B) that portion of the net income for such year, computed—

(i) without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code,

which the number of days in such year after December 31, 1953, bears to the total number of days in such year.

(g) Special transitional rules.—

(1) Losses for taxable years ending before January 1, 1954.—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.

(2) Losses for taxable years ending after December 31, 1953.—For purposes of section 122 of the Internal Revenue Code of 1939—

(A) the determination of the taxable years ending before January 1, 1954, to which a net operating loss for any taxable year ending after December 31, 1953, may be carried shall be made under subsection (b) (1) (A) of this section; and

(B) in determining the amount of the carryback to the first taxable year preceding the first taxable year ending after December 31, 1953, the portion of the net operating loss carried to such year shall be such net operating loss reduced by—

(i) the net income for the second preceding taxable year computed as if the second sentence of section 122 (b) (2) (B) of the Internal Revenue Code of 1939 applied, or

(ii) if smaller, the portion of the net operating loss which by reason of subsection (f) of this section is carried to the second preceding taxable year.

(3) Taxable years beginning after December 31, 1953, and ending before August 17, 1954.—In the case of a taxable year which begins after December 31, 1953, and ends before August 17, 1954—

(A) the net operating loss deduction for such year shall be computed as if subsection (a) of this section applied to such taxable year, and

(B) for purposes of the second sentence of subsection (b) (2), the taxable income for such taxable year shall be the net income for such taxable year, computed—

(i) without regard to paragraphs (1) and (2) of section 122(d) of the Internal Revenue Code of 1939, and

(ii) by allowing as a deduction an amount equal to the sum of the credits provided in subsections (b) and (h) of section 26 of such Code.

(4) Excess profits tax not affected.—For purposes of subchapter D of chapter 1 of the Internal Revenue Code of 1939, excess profits net income shall be computed as if this section had not been enacted and as if section 122 of such Code continued to apply to taxable years to which this subtitle applies.

(h) Disallowance of net operating loss of electing small business corporations.—In determining the amount of the net operating loss deduction under subsection (a) of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S.

(i) Carryback of net operating loss for taxable years beginning in 1957 and ending in 1958.—In the case of a taxable year beginning 1957 and ending in 1958, the amount of any net operating loss for such year which shall be carried to the third preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1957, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the third taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the third preceding taxable year.

(j) Carryover of net operating loss for certain regulated transportation corporations.—

(1) Definition.—For purposes of subsection (b) (1) (C), the term "regulated transportation corporation" means a corporation—

(A) 80 percent or more of the gross income of which (computed without regard to dividends and capital gains and losses) for the taxable year is derived from the furnishing or sale of transportation described in subparagraph (A), (C) (i), (E), or (F) of section 7701(a) (33) and taken into account for purposes of the limitation contained in the last two sentences of section 7701(a) (33),

(B) which is described in subparagraph (G) or (H) of section 7701(a) (33), or

(C) which is a member of a regulated transportation system.

(2) Regulated Transportation System.—For purposes of this subsection, a corporation shall be treated as a member of a regulated transportation system for a taxable year if—

(A) it is a member of an affiliated group of corporations making a consolidated return for such taxable year, and

(B) 80 percent or more of the aggregate gross income of the members of such affiliated group (computed without regard to dividends and capital gains and losses) for such taxable year is derived from sources described in paragraph (1) (A).

For purposes of subparagraph (B), income derived by a corporation described in subparagraph (G) or (H) of section 7701(a) (33) from leases described in subparagraph (G) thereof shall be considered as derived from sources described in paragraph (1) (A).

(3) Limitation.—For purposes of subsection (b)(1)(C)—

(A) a net operating loss may not be a net operating loss carryover to the 6th taxable year following the loss year unless the taxpayer is a regulated transportation corporation for such 6th taxable year; and

(B) a net operating loss may not be a net operating loss carryover to the 7th taxable year following the loss year unless the taxpayer is a regulated transportation corporation for the 6th taxable year following the loss year and for such 7th taxable year.

(4) Taxable years beginning in 1955 and ending in 1956.—In the case of a net operating loss for a taxable year beginning in 1955 and ending in 1956, the amount of such loss which may be carried—

(A) to the 6th taxable year following the loss year shall be the amount which bears the same ratio to the amount which (but for this paragraph) would be carried to such 6th taxable year as the number of days in the loss year after December 31, 1955, bears to the total number of days in the loss year, and

(B) to the 7th taxable year following the loss year shall be the amount (if any) by which (i) the amount carried to the 6th taxable year (determined under subparagraph (A)), exceeds (ii) the taxable income (computed as provided in subsection (b)(2)) for such 6th taxable year.

(k) Foreign expropriation loss defined.—For purposes of subsection (b)—

(1) The term "foreign expropriation loss" means, for any taxable year, the sum of the losses sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government of any foreign country, any political subdivision

thereof, or any agency or instrumentality of the foregoing. For purposes of the preceding sentence, a debt which becomes worthless shall, to the extent of any deduction allowed under section 166(a), be treated as a loss.

(2) The portion of the net operating loss for any taxable year attributable to a foreign expropriation loss is the amount of the foreign expropriation loss for such year (but not in excess of the net operating loss for such year).

(l) Cross references.—

(1) For treatment of net operating loss carryovers in certain corporate acquisitions, see section 381.

(2) For special limitation on net operating loss carryovers in case of a corporate change of ownership, see section 382.

Aug. 16, 1954, c. 736, 68A Stat. 63; Sept. 2, 1958, Pub.L. 85-866, Title I, §§ 14(a), (b), 64(b), Title II, § 203(a), (b), 72 Stat. 1611, 1656, 1678; Sept. 27, 1962, Pub.L. 87-710, § 1, 76 Stat. 648; Oct. 10, 1962, Pub.L. 87-792, § 7(f), 76 Stat. 829; Oct. 11, 1962, Pub.L. 87-794, Title III, § 317(b), 76 Stat. 889; Feb. 26, 1964, Pub.L. 88-272, Title II, §§ 210(a), (b) (5), 78 Stat. 47, 48, 115.

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(26 U.S.C. 1958 ed., Sec. 7805.)

Treasury Regulation 118 (1939 Code):

Par. 39.23(e)-3 **Loss of useful value.** (a) When, through some change in business conditions, the usefulness in the business of some or all of the assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the

difference between the basis (adjusted as provided in section 113(b) and par. 39.113(a) (14)-1 and 39.113(b) (1)-1 to 39.113(b) (4)-1, inclusive) and the salvage value of the property. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost or change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be fully explained in the return of income. The limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets.

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Treasury Regulations on Income Tax (1954 Code):

Par. 1.165-1 **Losses.**